

SECRETARIAT OF THE PACIFIC COMMUNITY

**THIRTY-FIRST MEETING OF THE
COMMITTEE OF REPRESENTATIVES OF GOVERNMENTS AND ADMINISTRATIONS**
(Nauru, 14-16 November 2001)

FINANCIAL POLICIES

(Paper presented by the Secretariat)

PURPOSE

1. The main purpose of this paper is to seek CRGA guidance and directions on several financial policies. The paper also provides additional information on financial policy matters following requests from CRGA members.

STRUCTURE

2. The paper is comprised of four major parts.
 - Part 1** discusses in detail the reserves and funds of the Secretariat.
 - Part 2** deals with the general approach to the setting of the annual budget, following the change from the *same real* to the *same nominal* policy.
 - Part 3** discusses the issues associated with the treatment of the newly established project management fees.
 - Part 4** describes the Secretariat's budget revision process.
3. For ease of discussion, the recommendations that this paper contains are also listed on the last page.

PART 1 : RESERVES AND FUNDS OF THE SECRETARIAT

General Comments

CRGA 30 requested clarification of the nature and status of the Secretariat's reserves and funds. Part 1 of the Working Paper provides this information. It also reports on actions that the Secretariat has taken to rationalise existing reserves and, where appropriate, proposes financial management guidelines for consideration by CRGA.

Categories of Reserves and Funds

The Secretariat has categorised reserves and funds into three groups according to the common purpose for which they have been established. The categories assist in simplifying the presentation of reserves and funds. They will also assist in establishing clear guidelines for their management and therefore will result in greater transparency. The groups are:

- (a) *General Reserve Fund*, the reserve that holds the accumulated surplus of the Secretariat's Core Budget operations;
- (b) *Specific Funds*, established for specific purposes. They are regarded as encumbered and generally not available for use other than for the specific purpose; and
- (c) *Special Funds*, which are self-funding, namely the Housing Fund and the Canteen Fund.

The terms *funds* and *reserves* are used interchangeably at the Secretariat and also in this Working Paper. Each of these groups is described in further detail below. Table 1 provides an overview of current funds and reserves.

Recommendation 1: That CRGA note the categories of reserves and funds.

Table 1: Overview of Funds and Reserves

(figures in CFP units)	Level as at 31.12.2000	Proposed desirable level
General Reserve Fund¹	722,157	8% of gov. income
Special Funds		
Emergency Evacuation	100,000	100,000
Plant & Equipment Replacement	321,336	400,000
Minor Works	27,500	100,000
Foreign Exchange Fluctuation	207,287	150,000–300,000
Conference Reserve	100,000	100,000
Specific Funds		
Canteen	220,260	
Housing	16,213	
Advance to Provident Fund	50,000	0 (to be closed)

¹ The figure provided in this table differs from the pre-audit figure contained in the circular to members, dated 6 July, on the new CROP Remuneration Package – Cost Analysis – SPC Implementation. The difference is largely a result of the audit requirement to recognise the liabilities due to local currency adjustments of professional salaries in the year 2000 Financial Statements.

(a) General Reserve Fund

*Regulation 14 – Principal Funds of the Organisation*² – stipulates:

“The working funds of the Organisation shall be held in two principal funds:

- (a) The Operating Fund, established pursuant to paragraph 48 of the Agreement establishing the Organisation; and
- (b) The **General Reserve Fund**, into which the annual operations of the Operating Fund is closed off.

The assessed contributions from members of the Organisation and any miscellaneous income shall be credited to the Operating Fund.”

Members may wish to note that the Financial Regulations define the Operating Fund as the “general fund used for recording all core receipts and payments”. For practical purposes, the fund is basically the same as the Core Budget. The agreement referred to is the Canberra Agreement.

With regard to guidelines for the General Reserve Fund, the Secretariat proposes the following to CRGA:

Recommendation 2 : That CRGA adopt the following guidelines:

- 2.1 Transfers from the General Reserve Fund require the approval of CRGA or Conference.
- 2.2 For the General Reserve Fund, the Secretariat aims to maintain a level that is equivalent to 8 per cent of core income from assessed membership contributions (approximately CFP units 600,000 in 2001). This level equates to approximately four weeks of Core Budget expenditure. Excess amounts will normally be brought back into operations through the annual budget preparation process.

(b) Specific Funds

The relevant financial regulation for funds and accounts **other** than the General Reserve Fund and the Core Budget is *Regulation 15 – Setting up and Use of Trust Funds and Special Accounts*. This regulation stipulates that:

“Trust Funds and Special Accounts may be established by the Director-General with the approval of the Conference. The purpose and limits of each Trust Fund and Special Account shall be clearly defined and unless otherwise directed by the Conference, such Funds and Accounts shall be administrated in accordance with these Regulations.”

² Regulations are quoted from the organisation’s Financial Regulations ‘Adopted at the Ninth Session of the Commission, and incorporating amendments made thereto at subsequent Sessions up to and including the Thirty-seventh South Pacific Conference, 1997’.

Members may wish to note that details on such funds have traditionally been included in the explanatory notes to the Secretariat's annual financial statements.

Specific Funds are currently comprised of five reserves or funds, as follows.

Emergency Evacuation Reserve

(Proposed desirable level: CFP units 100,000; actual level as at year-end 2000: CFP units 100,000)

Having entered into an arrangement with a company specialising in the logistics of international medical evacuations, the Secretariat now pays an annual subscription fee for this "stand-by" service. However, the actual costs of such an emergency evacuation would still need to be covered by the Secretariat. The reserve has been established for this purpose. Members may wish to note that the alternative would have been to take out insurance cover, which at approximately CFP units 40,000 to 50,000 per year was considered very expensive.

Plant & Equipment Replacement Fund

(Proposed desirable level: CFP units 400,000; actual level: CFP units 321,366)

The Plant & Equipment Replacement Fund was set up from surpluses from core activities and now receives an annual Core Budget allocation. This fund is used for the replacement of general plant and equipment such as furniture and computers. The main reason for this specific fund, however, is firstly, to provide for any unforeseeable need to replace costly items such as central air conditioning units and printing equipment and, secondly, to provide for large expensive items that – like cars - are replaced on a regular basis but only, say, every three to four years.

Minor Works Fund

(Proposed desirable level: CFP units 100,000; actual level: CFP units 27,500)

The Minor Works Fund has been established to cater for unforeseen essential repairs and maintenance to buildings and minor renovations that may become necessary during the course of the year but cannot be funded from the Core Budget allocation for maintenance.

Foreign Exchange Fluctuation Reserve

(Proposed desirable level: between CFP units 150,000 and 300,000 depending on circumstances; actual level: CFP units 207,287)

The Foreign Exchange Fluctuation Reserve captures foreign exchange variances that arise from the translation of foreign currencies to local currency. These variances may be realised gains (i.e. if the Secretariat has sold foreign currency) or unrealised gains or losses (e.g. if the Secretariat is holding foreign exchange that has increased or decreased in terms of the local currency value). It is essential to maintain this reserve, given the foreign exchange exposure that the Secretariat faces.

Conference Reserve

(Proposed desirable level: CFP units 100,000; actual level: CFP units 100,000)

Members are aware that significant core resources (typically around CFP 200,000) are required to hold the biannual Conference of the Pacific Community. The Conference Reserve provides an effective mechanism to set aside surplus funds from annual operations to be used in Conference years.

Redundant and Reclassified Reserves

Members may wish to note that the following reserves have become redundant or have been reclassified. *Medical Benefits* was a fund into which any difference between the actual payment to the Secretariat's medical insurance company and the amount budgeted for this purpose was closed off at the end of the year. These payments are now treated as any other expense would be; that is, variances are closed off at the end of the year through the normal process. The previous *Capital Fund* has been converted to *Deferred Income*. *Consolidation Exchange Fluctuation* was a fund used to provide for variances between the budgeted exchange rate for Suva operations and the actual CFP/FJD rate. Variances are now simply taken directly into the Income and Expenditure Account. The *Small Islands States Fund* is now treated as a normal non-core project.

With regard to Specific Funds, the Secretariat proposes the following for adoption by CRGA:

Recommendation 3 : That:

- 3.1 CRGA approve the definition and purpose of the Secretariat's Specific Funds as described in this Working Paper and endorse the proposed desirable levels for the Specific Funds.
- 3.2 CRGA note that the Director-General may establish Specific Funds with the approval of Conference or CRGA.
- 3.3 CRGA confirm that the Director-General may apply surpluses from annual core budget operations to Specific Funds within the relevant policy parameters approved by Conference or CRGA.
- 3.4 CRGA note that the Director-General may draw down Specific Funds during the course of the financial year for the purposes for which they have been established.

(c) Special Funds

Special Funds include the Housing Fund and the Canteen Fund. Both operate essentially as self-funding activities and use surpluses to improve their operations or the assets of the Secretariat. Accumulated surpluses may from time to time be taken into the General Reserve Fund or applied to Specific Funds as appropriate. The Secretariat is, for example, planning to transfer CFP units 100,000 to 150,000 out of the Canteen Fund.

The Annual Financial Statements for the year 2000 still show under Special Funds an "Advance to Provident Fund" (CFP units 50,000). Originally established as a buffer against capital losses of the Provident Fund, this reserve is no longer required because the Provident Fund, as a matter of policy, only holds very low risk investments such as treasury bonds or term deposits with reputable commercial banks. The amount will be transferred to the General Reserve Fund in 2001.

Recommendation 4: That CRGA note the Special Funds held by the Secretariat.

PART 2: APPROACH TO BUDGETING (*SAME NOMINAL*)

Under the former *same real* policy members' assessed contributions to the Core Budget were adjusted for movements in the CPIs in New Caledonia and Fiji. That policy has been replaced by the new *same nominal* policy, which stipulates that there will be no, or at least no automatic, increases in the budget from one year to the next. It was first proposed by a member in 1999 at CRGA/Conference and became effective for the 2001 budget.

Discussions at CRGA 30 demonstrated a need for further clarification of CRGA's preferred approach to budgeting. Members will recall, for example, that the Secretariat prepared the year 2001 budget on the basis of same levels of assessed contributions but was able to increase some of the other components of the income budget such as bank interest, which was used to finance programme activities. The Secretariat felt that it had followed CRGA/Conference instructions to the letter, noting among other points that the new policy had replaced the old *same real* policy, which was only applied to government contributions and not to the whole budget. CRGA members, however, had a number of concerns about the Secretariat's approach to preparing the 2001 budget.

General Discussion

SPC's Core Budget is made up of estimates of income and expenditure for the following year.

Income is derived from six sources:

1. assessed contributions to the Core Budget;
2. voluntary contributions to the Core Budget;
3. bank interest;
4. miscellaneous income (including revenues received from the hiring-out of facilities);
5. a Housing Fund levy; and
6. canteen rent.

Income from sources other than assessed contributions tends to fluctuate from one year to another, and may vary from projected budget levels. Any budget policy must therefore be flexible enough to allow the adjustments of these amounts from year to year and during the budget revision process. It would also appear desirable to maximise income from such non-government sources and to provide an incentive for managers to actively seek such additional income. It appears that a rigid and comprehensive application of the *same nominal* concept to all sources of income would provide neither that flexibility nor the incentive.

The *expenditure* budget itemises the resources required to deliver the outputs described in the budget narratives. Levels of expenditure are carefully planned to match the needs of the Secretariat and the availability of resources.

The motivation for the *same nominal* policy appears to have been a concern to introduce greater “rigour” or “fiscal discipline” into the budget preparation process. As a matter of principle, the Secretariat has presented balanced budgets – that is, budgets whose expenditure levels are not greater than projected resources. The annual financial statements (which are externally audited) confirm that the Secretariat has managed its financial resources within the given limits. Members are aware of the large efficiency gains that the Secretariat has achieved over the last few years through a rigorous cost-savings programme. The Secretariat believes that it has demonstrated the rigour of its financial management.

While the Secretariat will continue to explore further efficiency gains, it would seem inappropriate to raise any expectations of further significant savings. Moreover, at CRGA 29 and 30 the discussions about the introduction of project management fees indicate a widely held view among members that core resources are now severely stretched.

In the context of the budget policy discussions, members also raised concerns about a perceived lack of transparency in the process used to bring reserves back into operations. The Secretariat believes that the explanations and guidelines in this Working Paper (see Part 1) will fully address these particular concerns.

The Secretariat wishes to bring to the attention of CRGA a number of practical considerations that, in addition to the general policy concerns, may strengthen the case for a further refinement of CRGA’s budget policy. For example, the projected level of non-government income may fall. A strict application of the *same nominal* policy would then require an increase in government contributions to ensure the same level of income from one year to the next. A similar situation could arise if an existing member were to leave the organisation; the remaining members would then need to increase their respective contributions.

The discussions at CRGA 29 and 30 indicate that the main motivation for changing the budget policy was a desire to keep government contributions at current levels, if possible, and to ensure that the “starting point for budget discussions was at a more stringent level”. It is also appears that members do not wish to preclude the Secretariat from proposing “well-justified amendments” to the budget.

While the Secretariat does not advocate the re-establishment of the old *same real* approach to budgeting, it believes that the intentions of CRGA/Conference decisions may be more clearly and appropriately reflected in a refined budget policy.

Recommendation 5 : That CRGA adopt the following policy on the preparation of the Secretariat’s budget.

SPC’s income is derived from members’ assessed contributions and other sources such as interest, rentals and miscellaneous income. With regard to assessed contributions, it is Conference’s desire to maintain the contributions by current members at the preceding year’s level without adjustments for inflation. Budgets are therefore prepared on this basis. Increases are possible but require the Secretariat to submit appropriate requests for consideration by Conference and/or CRGA.

With regard to income from sources other than members' assessed contributions, Conference has directed the Secretariat to maximise income from such sources. SPC's expenditure budget will be no greater than the projected income and any approved transfers from the Secretariat's reserves and funds, requiring the Secretariat to present a balanced or surplus budget to its governing body.

PART 3 : THE PROJECT MANAGEMENT FEE

Recognising that the Secretariat's traditional sources of revenue were proving insufficient to provide high-quality support to growing work programme activities, in 2000 CRGA/Conference approved the concept of *project management fees* (also referred to as *administrative fees*). In consultation with the Secretariat's donor partners, these fees have been introduced during 2001.

A remaining issue is whether the income received from project management fees should be recognised as Core Budget income or as non-core income. Members will recall that CRGA 30 "suggested treatment of income received from such levies as a new recurrent income category in a way that would not increase the nominal Core Budget". The Secretariat is now seeking further clarification from CRGA on this direction, as it finds itself in a dilemma. If project management fees are recognised as a new recurrent (that is, core) income category, they will normally increase the nominal core income budget. On the other hand, if they are kept separate as non-core income as they are in 2001, the fees will not be recognised as a "new recurrent income category".

In considering the matter, it may be useful to recall that the fee was introduced to provide additional resources to strengthen those areas of the Secretariat that provide direct support services to work programmes but whose services normally cannot be charged directly to projects. Such areas include Information Technology, Finance and Publications. In the Secretariat's view, it would seem unusual that the fee is not applied directly to the Core Budget, which normally supports these services.

The issue was reviewed by a financial specialist in the context of the AusAID-sponsored review of SPC. The draft review report confirms the Secretariat's view about the unusual treatment of the project management fee. It also raises a concern that the current treatment of project management fees "promotes creative accounting and lessens, rather than enhances, transparency due to the restrictive requirements of the overarching 'same nominal' budget policy". While the Secretariat would not necessarily have put it quite as bluntly, it agrees that bringing the project management fee into the Core Budget does provide greater transparency and gives all CRGA members a direct opportunity to approve the use of these funds.

Members may also wish to note that in the Secretariat's Financial Regulations, *Regulation 14 – Principal Funds of the Organisation* stipulates that "The assessed contributions from members of the Organisation and **any miscellaneous income** shall be credited to the Operating Fund" (emphasis added by the Secretariat). That is, miscellaneous income is credited to the Core Budget. The current treatment of project management fees appears to be in conflict with this regulation.

The Secretariat's preference is to recognise project management fees as a new Core Budget income category.

Recommendation 6: That CRGA approve the recognition of revenues received from project management fees as a new Core Budget income category.

PART 4 : THE BUDGET REVISION PROCESS

CRGA/Conference have acknowledged the need for a mechanism with which the Secretariat can adjust the budget during the year. CRGA/Conference have also sought clarification on guidelines for the budget revision process.

As mentioned in Part 2, some of the concerns regarding the budget revision would appear to have stemmed from the approach that the Secretariat used to bring in funds from reserves during the revision of the year 2000 budget. The Secretariat believes that the guidelines proposed in Part 1 will fully address these concerns.

The current budget revision process usually involves one or several revisions during the year and takes account of changed circumstances such as urgent or unforeseen income and expenditure items. The revisions have tended to be relatively minor. A revised budget is presented for approval to CRGA; any additional required adjustments known at the time of the meeting are introduced by way of note or comment by the Director-General. Traditionally, CRGA has been asked to approve budget revisions, although technically only a report is necessary.

Financial Regulation 8 provides the authority for the Director-General to revise the budget. It also provides clear guidelines for the process. Members may wish to note that the regulation encourages transfers from the Administrative Budget to the Work Programme Budget but only in exceptional circumstances allows transfers from the Work Programme Budget to the Administrative Budget to achieve maximum effectiveness.

REGULATION 8 – TRANSFER OF CORE FUNDS BETWEEN BUDGETS

“The Director-General may:

- (a) Transfer anticipated Core fund savings under any sub-head to meet anticipated expenditure under any other sub-head of the same head.
- (b) Under the Administrative Budget, transfer available Core funds between budget heads; in the event there are excess funds under the Administrative Budget these can be transferred to the Work Programme Budget.
- (c) Within the Work Programme Budget, transfer Core funds between budget heads and in exceptional circumstances if warranted, may transfer unutilised Core funds available under the Programme Budget to rectify specific unforeseen and unbudgeted requirements in the Administrative Budget.

Details of such transfers are to be reported to Conference.”

As a matter of practice, the Secretariat has been reporting transfers to CRGA and Conference.

Recommendation 7: That CRGA note that Regulation 8 of the Secretariat's Financial Regulations provide the authority for the Director-General to revise the budget and appropriate guidelines for the revision process.

LIST OF RECOMMENDATIONS

1. That CRGA note the categories of reserves and funds.
2. That CRGA adopt the following guidelines:
 - 2.1 Transfers from the General Reserve Fund require the approval of CRGA or Conference.
 - 2.2 For the General Reserve Fund, the Secretariat aims to maintain a level that is equivalent to 8 per cent of core income from assessed membership contributions (approximately CFP units 600,000 in 2001). This level equates to approximately four weeks of Core Budget expenditure. Excess amounts will normally be brought back into operations through the annual budget preparation process.
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4. That CRGA note the Special Funds held by the Secretariat.
5. That CRGA adopt the following policy on the preparation of the Secretariat's budget.

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With regard to income from sources other than members' assessed contributions, Conference has directed the Secretariat to maximise income from such sources.

SPC's expenditure budget will be no greater than the projected income and any approved transfers from the Secretariat's reserves and funds, requiring the Secretariat to present a balanced or surplus budget to its governing body.

6. That CRGA approve the recognition of revenues received from project management fees as a new Core Budget income category.
7. That CRGA note that Regulation 8 of the Secretariat's Financial Regulations provides the authority for the Director-General to revise the budget and appropriate guidelines for the revision process.

25 September 2001